

GAO

United States General Accounting Office

Report to Congressional Committees

December 1998

DEFENSE INDUSTRY

Restructuring Costs Paid, Savings Realized, and Means to Ensure Benefits



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National Security and
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B-280962

December 1, 1998

Congressional Committees

Section 804 of the National Defense Authorization Act for Fiscal Year 1998¹ requires us to (1) provide updated information on restructuring costs paid and savings realized by the Department of Defense (DOD) from restructuring activities carried out by defense contractor business combinations certified under Public Law 103-337, (2) develop and use a methodology to determine the savings on the prices paid on a meaningful sample of defense contracts, and (3) make any recommendations considered appropriate. This report responds to the legislative requirement and is the last in a series of required reports on defense contractor restructuring.

This report includes information on the six business combinations for which DOD, as of September 30, 1998, had certified that the projected restructuring savings should exceed associated restructuring costs.² These combinations are:

- United Defense Limited Partnership (UDLP), a joint venture between FMC Corporation's Defense Systems Group and Harsco Corporation's BMY Combat Systems Division;
- Martin Marietta Corporation's acquisition of General Electric Company's aerospace and other business segments;
- Martin Marietta's acquisition of General Dynamics Corporation's Space Systems Division;
- Northrop Corporation's acquisition of the Grumman Corporation and the Vought Aircraft Company to form the Northrop Grumman Corporation;
- the merger of the Lockheed Corporation and Martin Marietta to form the Lockheed Martin Corporation; and
- Hughes Electronics' acquisition of CAE-Link Corporation.

This report also includes information on a seventh combination, Hughes Aircraft Company's acquisition of General Dynamics' missile operations. This business combination occurred before the DOD certification requirement was established; however, DOD has included information about the combination in its annual reports to Congress on defense

¹Public Law 105-85, November 18, 1997.

²On October 14, 1998, DOD issued certifications related to (1) Lockheed Martin Corporation's acquisition of most of the Loral Corporation and (2) Westinghouse Electric Corporation's acquisition of Norden Systems. Norden is now part of the Northrop Grumman Corporation, through Northrop Grumman's acquisition of Westinghouse Electric's Electronic Systems.

contractor restructuring activities. Accordingly, we are including information about the combination in this report.

We have previously reported on several aspects of defense contractor restructuring. See Related GAO Products at the end of this report.

Results in Brief

In April 1998, we reported that DOD estimated it would save a net of \$3.3 billion between 1993 and 2000 from restructuring activities carried out by the seven business combinations. We also reported that DOD estimated it had realized savings of about \$1.9 billion as of August 1997, or more than half of the expected savings. Now, DOD estimates it has realized savings of about \$2.1 billion, or 64 percent of the expected savings.

While we determined that selected restructuring activities had lowered the operational costs of the business combinations by hundreds of millions of dollars, it was not feasible to develop a methodology for precisely determining how contract prices were affected. To make such a determination requires isolating the impact of restructuring from nonrestructuring-related factors, such as changes in business volume, quantities purchased, and accounting practices. DOD, the contractors, and we were not able to isolate the effects of restructuring from those of other factors. However, other methods exist through which DOD can ensure that it receives its equitable share of restructuring savings in a timely manner.

Background

To encourage defense contractor consolidations, DOD announced in July 1993 that it would pay for restructuring costs on transferred flexibly priced contracts,³ provided that (1) the restructuring costs were allowable under the Federal Acquisition Regulation and (2) a DOD contracting officer determined that the business combination was expected to result in overall reduced costs to DOD or preserve a critical defense capability. Concerns over the payment of restructuring costs led Congress in 1994 to pass Public Law 103-337, which required a senior DOD official to certify that projections of restructuring savings were based on audited cost data and that the projected savings should result in overall reduced costs to DOD.

³After a business combination, contracts are transferred from one contractor to another through written agreements executed by the seller, buyer, and government. These agreements cite the government's approval to transfer its contracts. Flexibly priced contracts are those under which the total amount paid to the contractor depends on the allowable costs the contractor incurs in performing the work.

In 1996, Congress passed Public Law 104-208, which stipulated that for business combinations occurring after September 30, 1996, projected savings had to (1) be at least twice the amount of costs allowed or (2) exceed the costs allowed, provided the Secretary of Defense determined that the combination would result in the preservation of a critical capability. Public Law 105-85 made these requirements permanent. None of the combinations discussed in this report were subject to the two-to-one ratio requirement because they occurred before this requirement was established. The Secretary of Defense is required to report to Congress annually through 2002 on DOD's experience with defense contractor business combinations occurring on or after August 15, 1994.

Restructuring Savings and Costs

In April 1998, we reported that, for the seven business combinations, DOD expects to save a net of almost \$3.3 billion between 1993 and 2000 from restructuring activities, such as laying off workers, closing facilities, and relocating employees and equipment. Table 1 shows DOD's projection of its share of restructuring savings and costs for these business combinations.

Table 1: DOD's Projected Restructuring Savings and Costs

| Business combination | Dollars in millions | | |
|---|----------------------|--------------------|--------------------|
| | Total savings | Total costs | Net savings |
| Hughes - General Dynamics missile operations ^a | \$505.8 | \$132.5 | \$373.3 |
| UDLP | 79.7 | 29.1 | 50.6 |
| Martin Marietta - General Electric Aerospace | 305.4 | 156.3 | 149.1 |
| Martin Marietta - General Dynamics Space Systems Division | 139.6 | 50.7 | 88.9 |
| Northrop - Grumman - Vought | 263.4 | 46.7 | 216.7 |
| Lockheed - Martin Marietta | 2,675.8 | 405.9 | 2,269.9 |
| Hughes - CAE-Link | 148.1 | 35.0 | 113.1 |
| Total | \$4,117.8 | \$856.2 | \$3,261.6 |

^aWith the exception of Hughes - General Dynamics, all costs and savings figures reflect the values used in DOD's certification decisions. Because the Hughes - General Dynamics combination occurred before the requirement for DOD to certify that savings will exceed costs, DOD did not prepare a comparable figure for total restructuring savings. The \$505.8 million shown reflects DOD's share of a March 1997 estimate of total restructuring savings; the cost figure represents DOD's original estimate of costs.

We reported in September 1998⁴ that our work had shown that selected restructuring activities at 10 contractor business segments had enabled the contractors to reduce their projected operating costs by hundreds of millions of dollars. These reductions benefited DOD because defense contracts' costs were lower than they would have been if the restructuring activities had not occurred. However, not all of the restructuring savings shown in table 1 may be directly attributable to restructuring.

We noted in our April 1998 report⁵ that Lockheed Martin had projected about \$489 million of restructuring savings from increased operational efficiencies at its Missiles & Space segment by adopting improved business practices. Contractor officials acknowledged that some of the improvements and associated savings could have been implemented without restructuring because various efforts were already underway or planned to improve the segment's operational efficiency prior to restructuring. However, these officials believed that the business combination provided the means to overcome organizational and cultural barriers that might otherwise have hindered these efforts.

Subsequently, we reported in September 1998 that Lockheed Martin did not fully consider the impact of normal downsizing activities when estimating restructuring savings. For example, Lockheed Martin attributed 1,153 support personnel reductions at its Missiles & Space segment in 1995 to restructuring activities. However, before its merger with Martin Marietta, Lockheed had forecasted that its total personnel level at this segment would decrease by 849 in 1995. Because Lockheed Martin did not consider reductions that were already planned, the amount of savings that was directly attributed to restructuring for 1995 may be overstated by \$170 million.

While our work raised questions as to whether all of the projected savings are directly related to restructuring, these two overstatements would not have affected DOD's decision to pay restructuring costs because of the large amount of projected savings from the Lockheed - Martin Marietta business combination.

We reported in April 1998 that DOD estimated it had realized a net savings of about \$1.9 billion from the seven business combinations. Now, DOD

⁴Defense Contractor Restructuring: Benefits to DOD and Contractors (GAO/NSIAD-98-225, Sept. 10, 1998).

⁵Defense Industry Restructuring: Updated Cost and Savings Information (GAO/NSIAD-98-156, Apr. 30, 1998).

estimates it has realized a net savings of about \$2.1 billion (see table 2). The estimated savings realized represent about 64 percent of the restructuring savings expected at the time of certification.

Table 2: DOD's Estimate of Restructuring Savings Realized and Costs Paid

| Dollars in millions | | | |
|--|-------------------------|-------------------|--------------------|
| Business combination | Savings realized | Costs paid | Net savings |
| Hughes - General Dynamics missile operations ^a | \$505.8 | \$121.4 | \$384.4 |
| UDLP ^a | 37.6 | 14.0 | 23.6 |
| Martin Marietta - General Electric Aerospace ^a | 198.2 | 71.9 | 126.3 |
| Martin Marietta - General Dynamics Space Systems Division ^a | 163.7 | 26.4 | 137.3 |
| Northrop - Grumman - Vought ^b | 113.0 | 17.5 | 95.5 |
| Lockheed - Martin Marietta ^b | 1,406.6 | 49.7 | 1,356.9 |
| Hughes - CAE-Link ^b | 37.3 | 13.8 | 23.5 |
| Total | \$2,462.2 | \$314.7 | \$2,147.5 |

^aAs of August 31, 1997.

^bAs of December 31, 1997.

Source: GAO analysis of DOD's most recent data, as reflected in DOD's November 1997 and March 1998 restructuring reports, respectively.

We commented in the April 1998 report that caution should be exercised when interpreting DOD's reported restructuring savings. We noted that the savings DOD reported were generally not developed from a detailed analysis of the effect of restructuring on individual contract prices but rather were estimated using the same or similar methodologies employed to estimate savings during the certification process. DOD has consistently stated that it is inherently difficult to precisely identify the amount of actual savings realized from restructuring activities.

Methodology for Determining Savings on Specific Contracts Not Feasible

It is not feasible to develop and apply a standard methodology that can be used to separate the precise impact of restructuring from the impact that other factors have on contract prices. Determining the precise impact that restructuring activities have on a contract price requires isolating the effect of restructuring from nonrestructuring-related factors. In its annual reports to Congress, DOD has stated that factors such as inflation, business fluctuations, accounting system changes, quantities purchased, and subsequent reorganizations, affect a contractor's overall cost of

operations. DOD noted that it is not feasible to precisely isolate the impact of restructuring from the impact of these other factors. As previously reported, our work substantiates DOD's position.

During our work for the September 1998 report, the contractors we visited provided several examples that they believed demonstrated how specific contract prices were affected by restructuring. For example, Martin Marietta provided information showing that the Navy purchased 25 test equipment items at a unit price of \$1,270,524 before its acquisition of the General Electric business segments and 25 of the same test equipment items at a unit price of \$1,246,230 after the acquisition and subsequent restructuring. Even though the unit price was \$24,294 lower after restructuring, neither we nor contractor officials could isolate the impact of restructuring from the influence of other factors, such as learning curve improvement and business base changes. Contractor officials believe the unit price reduction was attributable, in part, to restructuring activities but acknowledged that the other factors also affected the unit price.

A similar problem existed with the other examples provided by the contractors. Neither we nor the contractors could separate the effect of restructuring from the influence of other factors that also affected the contract prices. Speaking on behalf of business combinations included in our September 1998 report, the Aerospace Industries Association noted that it was not practical to determine the impact of restructuring on contract prices because so many variables affect prices.

Other Means to Ensure DOD Receives Restructuring Benefits

While it is not feasible to develop a methodology to precisely determine the impact of restructuring on contract prices, our work has shown that there are other ways to ensure that DOD receives benefits from restructuring activities. In particular, prompt adjustments of forward pricing rates⁶ and the use of reopeners clauses would enable DOD to share in the benefits of restructuring in an equitable and timely manner.

Before DOD can benefit from restructuring activities, restructuring savings must be incorporated into a contractor's forward pricing rates used to price defense contracts. DOD's acquisition regulations stipulate that its contracting officers should adjust a contractor's forward pricing rates as soon as practical upon receipt of a restructuring proposal. In commenting on our April 1998 report, DOD highlighted this requirement by stating that,

⁶DOD and contractors use forward pricing rates to facilitate the pricing of contracts. These rates are applied against a contractor's proposed direct costs to estimate the amount of overhead costs to be allocated to a particular contract.

in reviewing contractor restructuring proposals associated with business combinations, one of its major concerns is that restructuring costs and savings are factored into forward pricing rates as soon as possible so that the net savings are priced into new contracts. We strongly agree with DOD's position. It is imperative that contracting officers adjust the forward pricing rates as soon as possible after a contractor quantifies its estimated restructuring savings so that the lower rates can be used to price contracts.

Before forward pricing rates are adjusted and used to price contracts, contracting officers should incorporate reopeners clauses in noncompetitive fixed-price contracts to enable DOD to recoup its equitable share of savings under these contracts. We reported in July 1998⁷ that it took an average of about 21 months from the announcement of a business combination to the time that contractors reflected restructuring savings in forward pricing rates. During that time, DOD awarded over 600 fixed-price contracts or contract modifications worth about \$3.9 billion to these contractors. Despite repeated recommendations from the Defense Contract Audit Agency (DCAA) and the Defense Contract Management Command (DCMC), contracting officers rarely included reopeners clauses for savings in fixed-price contracts awarded during this period.

The use of reopeners clauses has resulted in recouping restructuring savings. In our September 1998 report, for example, we discussed a case where the contracting officer had included a reopeners clause in a fixed-price foreign military sales contract for self-propelled howitzers awarded to UDLF, which required UDLF to reduce the contract price after restructuring its operations. Using a proposal developed by UDLF showing the impact of restructuring on the contract, the contracting officer negotiated a \$1.8-million reduction to the contract's \$48.5-million price. The \$1.8 million could not have been recovered from this fixed-price contract had the reopeners clause not been included in the contract at the time it was awarded.

We reported in July 1998 that DOD contracting officers and contractors were reluctant to use reopeners clauses. We, therefore, recommended that the Secretary of Defense revise DOD's regulations to require that contracting officers include the clauses in noncompetitive fixed-price contracts negotiated before the benefits of restructuring savings were reflected in forward pricing rates. We also recommended that, if the

⁷Defense Contractor Restructuring: DOD Risks Forfeiting Savings on Fixed-Price Contracts (GAO/NSIAD-98-162, July 17, 1998).

clauses were not included, contracting officers provide a written justification in the negotiation records as to why they were not needed.

In responding to our recommendations, DOD agreed to add a new provision to its regulations requiring contracting officers to consider using a reopeners clause. DOD did not believe, however, that the use of reopeners clauses should be mandatory. DOD stated that contracting officers must be permitted to exercise professional judgment to decide when the clause is appropriate. DOD further stated that documenting the reason for not using a reopeners clause would result in an unnecessary administrative burden and was contrary to the principles of acquisition reform.

DOD's action to add a new provision to its regulations requiring contracting officers to consider using reopeners clauses is a step in the right direction. However, we continue to believe that contracting officers should be required to document in the negotiation records the reason they did not include a reopeners clause in noncompetitive fixed-price contracts.

Conclusions

While our work has shown that DOD is benefiting from defense contractor restructuring activities, it is not feasible to develop a standard methodology for precisely determining the impact of these benefits on specific contract prices. However, DOD could ensure that it receives its equitable share of restructuring savings in a timely manner by having its contracting officers (1) adjust forward pricing rates as soon as possible to reflect restructuring savings and (2) include reopeners clauses in noncompetitive fixed-price contracts awarded before the forward pricing rates are adjusted. DOD has agreed to revise its regulations to require contracting officers to consider the use of reopeners clauses.

Agency Comments

DOD concurred with the report's findings. DOD's comments are included as appendix I.

Scope and Methodology

In responding to the legislative requirement, we primarily relied on our prior work on defense contractor restructuring activities. As part of our prior work, we reviewed information prepared during DOD's certification process, including the contractor's restructuring proposal, DCAA audit reports, negotiation memorandums, and other pertinent information to determine the amount of restructuring savings and costs expected for each of these business combinations. To determine the amount of restructuring

costs paid and estimated savings realized, we reviewed DOD's November 1997 and March 1998 reports to Congress on defense industry restructuring.

To determine the feasibility of developing a methodology for assessing restructuring savings on individual contract prices, we reviewed restructuring activities at 10 contractor business segments, including at least 1 segment from each of the 7 business combinations. We generally selected those business segments with the largest projected amount of restructuring savings. In assessing whether restructuring savings could be traced to contract prices, we tried to compare the overhead rates that were in effect before restructuring with the rates that were in effect after restructuring. We also examined contract-related documents to determine if direct costs were less than before restructuring.

Also, we requested that contractor officials identify comparable items that DOD purchased before and after restructuring. We accepted the items the contractors identified and did not make an independent evaluation to determine whether they identified all available comparable items. We compared the prices DOD paid for these items before and after restructuring to determine if the prices had been affected by restructuring and other factors. In addition, we determined whether contracting officers had included downward-only reopeners clauses in fixed-price contracts negotiated before the contractors had adjusted their forward pricing rates to reflect the impact of restructuring. For those contracts containing such clauses, we determined whether contracting officers had exercised the clauses and, if so, the amounts by which the contracts' prices were reduced.

We discussed the results of our analyses with officials from the business combinations, DOD, DCMC, and DCAA. We performed work in September 1998 to update some of the information included in our prior reports. The work was carried out in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Secretary of Defense; the Commander, DCMC; the Director, DCAA; and the Director, Office of Management and Budget. Copies will also be made available to others upon request.

Please contact me at (202) 512-4841 if you or your staff have any questions concerning this report. Major contributors to this report are listed in appendix II.

A handwritten signature in black ink, appearing to read "David E. Cooper". The signature is fluid and cursive, with "David" on top, "E." in the middle, and "Cooper" on the bottom right.

David E. Cooper
Associate Director
Defense Acquisitions Issues

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Abbreviations

| | |
|------|-------------------------------------|
| DCAA | Defense Contract Audit Agency |
| DCMC | Defense Contract Management Command |
| DOD | Department of Defense |
| UDLP | United Defense Limited Partnership |

Comments From the Department of Defense



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ACQUISITION AND
TECHNOLOGY

DP/CPF

November 6, 1998

Mr. David E. Cooper
Associate Director, Defense Acquisitions Issues
National Security and International
Affairs Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Cooper:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report GAO/NSIAD-99-22, DEFENSE INDUSTRY: Restructuring Costs Paid, Savings Realized, and Means to Ensure Benefits, dated October 28, 1998 (GAO Code 707382/OSD Case 1712).

The DoD concurs with the GAO findings of the draft report. The report contains no recommendation.

The GAO reported that DoD expects to save a net of \$3.3 billion between 1993 and 2000 from restructuring activities carried out by seven business combinations. GAO also reported that DoD estimates it has now realized net savings of about \$2.1 billion, or 64 percent, of the expected savings.

The GAO found that selected contractor restructuring activities had reduced their operating costs by hundreds of millions of dollars, and that these reductions benefited DoD because the costs of defense contracts were lower than they would have been had the restructuring activities not occurred. The GAO was not able to develop and apply a standard methodology that can be used to identify the precise impact of restructuring activities on specific DoD contract unit prices due to factors such as inflation, business fluctuations, changes in quantities purchased, accounting system changes, and subsequent reorganizations, which also affect a contractor's overall cost of operations and impact the unit prices of defense goods. The GAO work substantiates DoD's position as reported in its annual reports to the Congress on restructuring costs.



Appendix I
Comments From the Department of Defense

The GAO concluded that DoD can ensure that it receives its equitable share of restructuring savings in a timely manner by having its contracting officers adjust forward pricing rates as soon as possible to reflect restructuring savings, and include reopeners clauses in noncompetitive fixed-price contracts awarded before the forward pricing rates are adjusted. The GAO acknowledged that DoD's restructuring regulations require its contracting officers to adjust a contractor's forward pricing rates as soon as practicable upon receipt of a contractor's restructuring proposal, and that DoD has agreed to add a new provision to its restructuring regulations requiring contracting officers to consider the use of reopeners clauses in these type contracts, depending upon the particular circumstances involved.

Thank you for providing us the opportunity to comment on the draft report.

Sincerely,



Eleanor R. Spector
Director, Defense Procurement

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Related GAO Products

Defense Contractor Restructuring: Benefits to DOD and Contractors
(GAO/NSIAD-98-225, Sept. 10, 1998).

Defense Contractor Restructuring: DOD Risks Forfeiting Savings on Fixed-Price Contracts (GAO/NSIAD-98-162, July 17, 1998).

Defense Industry Restructuring: Updated Cost and Savings Information
(GAO/NSIAD-98-156, Apr. 30, 1998).

Defense Industry Restructuring: Clarification of Cost and Savings Issues
(GAO/NSIAD-97-186R, June 17, 1997).

Defense Industry Restructuring: Cost and Savings Issues (GAO/T-NSIAD-97-141, Apr. 15, 1997).

Defense Restructuring Costs: Information Pertaining to Five Business Combinations (GAO/NSIAD-97-97, Apr. 1, 1997).

Defense Restructuring Costs: Projected and Actual Savings From Martin Marietta Acquisition of GE Aerospace (GAO/NSIAD-96-191, Sept. 5, 1996).

Defense Contractor Restructuring: First Application of Cost and Savings Regulations (GAO/NSIAD-96-80, Apr. 10, 1996).

Defense Restructuring Costs: Payment Regulations Are Inconsistent With Legislation (GAO/NSIAD-95-106, Aug. 10, 1995).

Overhead Costs: Defense Industry Initiatives to Control Overhead Rates
(GAO/NSIAD-95-115, May 3, 1995).

Defense Downsizing: Selected Contractor Business Unit Reactions
(GAO/NSIAD-95-114, May 3, 1995).

Defense Industry Consolidation: Issues Related to Acquisition and Merger Restructuring Costs (GAO/T-NSIAD-94-247, July 27, 1994).

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